

More evidence that financial markets imposed excessive austerity in the eurozone

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The decision by the ECB in 2012 to commit itself to unlimited support of the government bond markets was a game changer in the eurozone crisis. It had dramatic effects. By taking away the intense existential fears that the collapse of the eurozone was imminent, the ECB's lender-of-last-resort commitment pacified government bond markets and led to a strong decline in the spreads of the eurozone countries.

The decision of the ECB also provides an interesting experiment to test theories about how spreads (the difference between national government bond rates and the German rate) are formed. According to one theory, the surging spreads observed from 2010 to the middle of 2012 were the result of deteriorating fundamentals (e.g. domestic government debt, external debt, competitiveness, etc.). The implication of that theory is that the only way to bring these spreads down is by improving the fundamentals, mainly by austerity programmes aimed at reducing government budget deficits and debts. Another theory, while accepting that fundamentals matter, recognises that collective movements of fear and panic can have dramatic effects on spreads. These movements can drive the spreads away from underlying fundamentals, very much akin to the way stock markets prices can be gripped by a bubble pushing them far away from underlying fundamentals. The implication of that theory is that while fundamentals cannot be ignored, there is a special role for the central bank that has to provide liquidity in times of market panic (De Grauwe, 2011).

Figure 1 provides some evidence allowing us to discriminate between these two theories. We show the change in the spreads in the eurozone from the middle of 2012, when the ECB announced its OMT (outright monetary transactions) programme, to the beginning of 2013 on the vertical axis. On the horizontal axis we present the initial spread, i.e. the one prevailing in the middle of 2012. We find a surprising phenomenon. The initial spread (i.e. in 2012Q2) explains almost all the subsequent variation in the spreads. Thus the country with the largest initial spread (Greece) experienced the largest subsequent decline; the country with the second-largest initial spread (Portugal) experienced the second-largest subsequent decline, etc. In fact, the points lie almost exactly on a straight line going through the origin. The regression equation indicates that 97% of the variation in the spreads is accounted for by the initial spread. Thus it appears that the only variable that matters to explain the size of the

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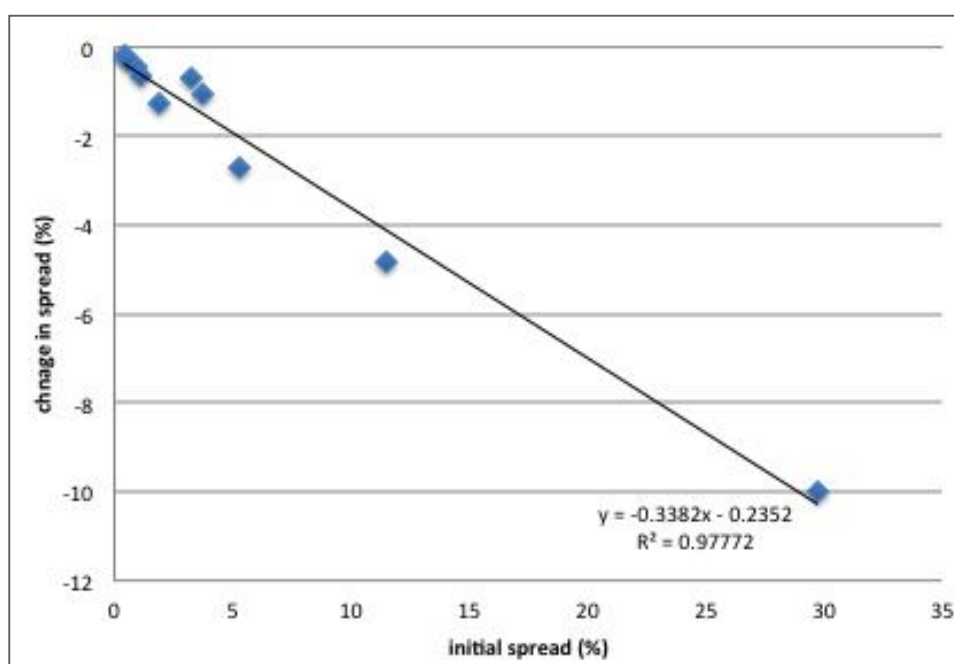
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decline in the spreads since the ECB announced its determination to be the lender of last resort (OMT) is the initial level of the spread. Countries whose spread had climbed the most prior to the ECB announcement experienced the strongest decline in their spreads – a remarkable phenomenon.

In De Grauwe & Ji (2012), we provided evidence that prior to the regime shift made possible by the ECB, a large part of the surges in the spreads were the result of market sentiment of fear and panic that had driven the spreads away from their underlying fundamentals. The evidence provided by Figure 1 tends to confirm this. By taking away the fear factor, the ECB allowed the spreads to decline. We find that the decline in the spreads was the strongest in the countries where the fear factor had been the strongest.

Figure 1. Change in spread and initial spread in % (from 2012Q2 to 2013 Q1)



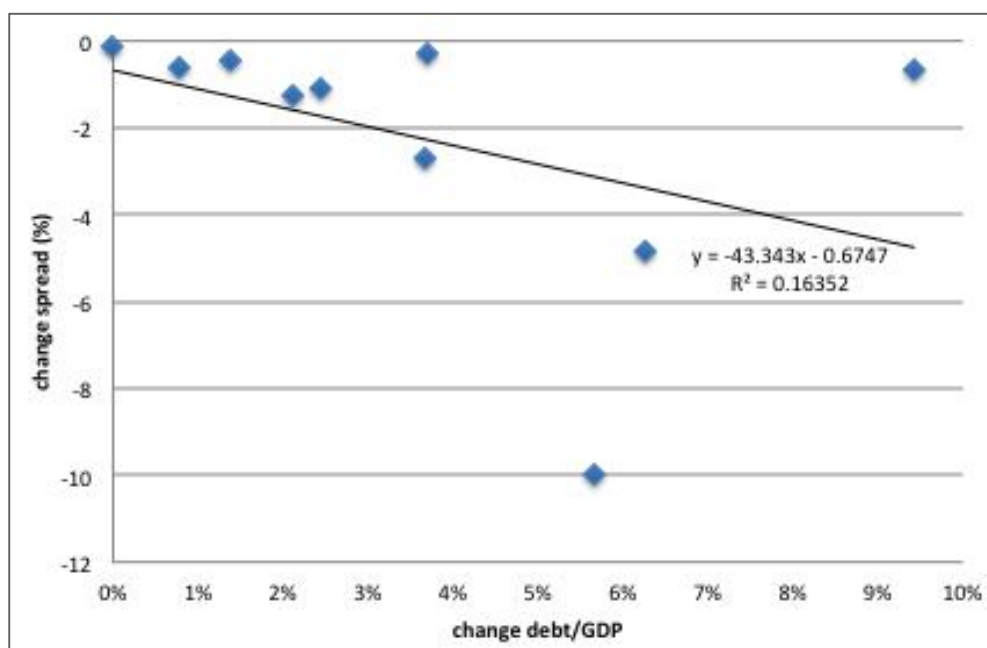
Source: Datastream (Oxford Economics).

What about the role of fundamentals in explaining the decline in the spreads observed since the middle of 2012? In Figure 2 we provide some evidence. We selected the change in the government debt/GDP ratio as the fundamental variable. It appears from many studies – Aizenman & Hutchinson (2012), Attinasi et al. (2009), Beirne & Fratscher (2012), De Grauwe & Ji (2012) – that the debt/GDP ratio is the most important fundamental variable influencing the spreads. We observe two interesting phenomena in Figure 2. First while the spreads declined, the debt/GDP ratio continued to increase in all countries after the ECB announcement. Second, the change in the debt/GDP ratio is a poor predictor of the declines in the spreads (as can be seen from the regression equation). Thus the decline in the spreads observed since the ECB announcement appears to be completely unrelated to the changes of the debt-to-GDP ratios. If anything, the fundamentalist school of thinking would have predicted that as the debt-to-GDP ratios increased in all countries, spreads should have increased rather than decline.

From the previous discussion one can conclude that a large component of the movements of the spreads since 2010 was driven by market sentiment. It was fear and panic that first drove the spreads away from their fundamentals. Later as the market sentiment improved, thanks

to the announcement of the ECB, these spreads declined spectacularly. This was predicted in De Grauwe (2011), Wolf (2011) and Wyplosz (2011).

Figure 2. Change in debt/GDP and spread since 2012Q2



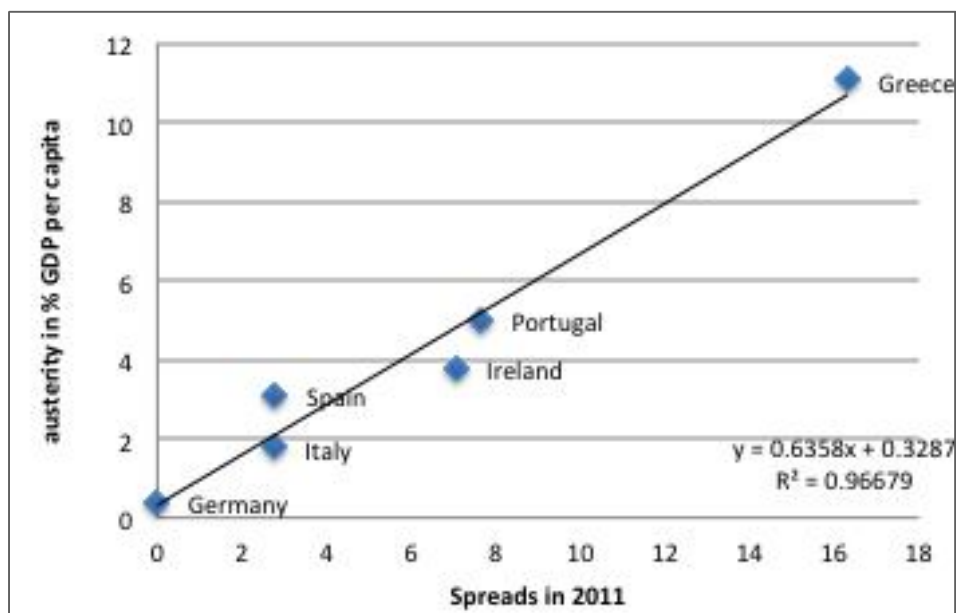
Source: Datastream (Oxford Economics).

The fact that spreads were largely unrelated to real economic fundamentals does not mean that they were not without influence for the real economy. The main channel of influence of the spreads was through policy reactions. As the spreads increased due to market panic, these increases also gripped policy-makers. Panic in the financial markets led to panic in the world of policy-makers in Europe. As a result of this panic, rapid and intense austerity measures were imposed on countries experiencing these increases in spreads. The imposition of dramatic austerity measures was also forced by the fact that countries with high spreads were pushed into a liquidity crisis by the same market forces that produced the high spreads (De Grauwe, 2011). This forced these countries to beg “hat in hand” for funding from the creditor countries.

We present some evidence on the power of market panic in imposing austerity in Figure 3. This shows the average spreads in 2011 on the horizontal axis and the intensity of austerity measures as measured by the Financial Times¹ (as a percent of per capita GDP). It is striking to find a very strong positive correlation. The higher the spreads in 2011, the more intense were the austerity measures. The intensity of the spreads can be explained almost uniquely by the size of the spreads (the $R^2 = 0.97$).

¹ Financial Times (<http://www.ft.com/cms/s/0/feb598a8-f8e8-11e0-a5f7-00144feab49a.html#axzz2JSOwncys>).

Figure 3. Austerity measures and spreads in 2011



Source: Financial Times (<http://www.ft.com/cms/s/0/feb598a8-f8e8-11e0-a5f7-00144feab49a.html#axzz2JSOwncys>) and Datastream.

Two conclusions can be drawn from the previous analysis. First, the power of the ECB to counter market sentiments of fear and panic is great. Up to now this power has been exerted only by announcement. Not a single shot was fired. It is clear, however, that if market sentiments were to turn around again, the ECB would be forced to fire, i.e. to actually intervene. Otherwise it would immediately lose its credibility and its power.

Second, the evidence provided here suggests that since the start of the debt crisis financial markets have provided wrong signals. Led by fear and panic, they pushed the spreads to artificially high levels and forced countries lacking the cash into intense austerity producing great suffering in these countries. They also gave these wrong signals to the European authorities, in particular the European Commission that went on a crusade trying to enforce more austerity. Thus financial markets acquired great power in that they spread panic into the world of the European authorities, who translated the market panic into enforcing excessive austerity. While the ECB finally acted in September 2012, it can also be argued that had it acted earlier, much of the panic in the markets may not have occurred and the excessive austerity programmes might have been avoided.

In order to avoid misunderstanding: we are not saying that southern European countries will not have to go through austerity so as to return to sustainable government finances. They will have to do so. What we are claiming is that the timing and the intensity of the austerity programmes have been dictated too much by market sentiment instead of being the outcome of rational decision-making processes.

There can be little doubt that the governance of the eurozone will have to change in order to avoid being taken hostage again by volatile market sentiments.

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